Michael C Bonello: The challenges facing Malta's banking system

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, at the Second Annual Conference of Finance Malta, Valletta, 29 May 2009.

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Introduction

This conference about Malta’s financial services industry is being held in the midst of the most severe global financial crisis since the Great Depression and whose consequences for the real economy in terms of output and employment losses are proving to be the most devastating in living memory. It is a crisis, therefore, which cannot but have repercussions on a small, open economy like Malta’s that is highly integrated with the world economy through trade and finance. These circumstances present challenges for the domestic banking system, and in addressing them it is important to recognise the implications for the economy at large. A sound, adaptable and innovative banking system is a prerequisite for sustainable development.

The birth of a modern banking system

Malta’s recent banking history has indeed tended to mirror policy shifts in the broader economy. The nationalisation of the major banks in the 1970s was itself recognition that the centralisation of economic activity could not be achieved without state control of financial resources, including credit flows. Lending rates were set by the minister of finance while the central bank controlled deposit rates. Nominal interest rates were kept artificially low, often resulting in negative real interest rates. Unable to adjust lending rates according to the creditworthiness of borrowers, banks resorted to significant collateral requirements and to credit rationing. The heavy reliance on real estate as collateral, the insufficient importance attached to the viability of project proposals, along with the absence of a capital market meant than savings were often not channelled efficiently into productive investment. The resulting misallocation of resources served to compound the distortions that would proliferate in the rest of the economy.

A sea change in economic strategy occurred in the late eighties with the introduction of policies to reduce the overbearing state presence. These included a gradual reorientation towards a more market-oriented banking system and a monetary policy that operated more through incentives and less through command. A first reduction in the government’s shareholdings in banks took place during 1990/1991, and this was accompanied by a strengthening of the regulatory framework, including measures to enhance the capital base of banks through profit retention and the issue of new stock. A capital market, in the form of the Malta Stock Exchange, was also created. Supporting economic reforms included a relaxation of the extensive system of import controls, the partial lifting of wage-price controls and an overhaul of the income tax regime.

While reforms were incremental, a number of landmarks stand out. In 1994, for example, a comprehensive package of legislation was enacted as part of a strategy to further develop Malta as an international financial centre. The thrust of this initiative was to promote competition by opening up the licensing process and removing administrative controls on lending, while stressing the importance of maintaining adequate capital and managing risk appropriately. At the same time, the Malta Financial Services Centre was established as the regulator for financial services other than banking, which remained the responsibility of the Central Bank of Malta.

Also in 1994, responsibility for monetary policy was moved to the Central Bank of Malta. The introduction of reserve requirements and the Bank’s engagement in open market operations paved the way for the establishment of a market-driven interest rate structure, which is of paramount importance for the transmission of monetary policy. To promote activity in the money market and bolster its own ability to steer interest rates, the Bank initiated weekly auctions to influence the size of the monetary base, while gaining control over the excess liquidity of the banking system.

Further steps were subsequently taken to create an independent regulatory framework in line with international standards. In 2002 the renamed Malta Financial Services Authority took over from the Central Bank of Malta the responsibility for supervising the banks and the stock exchange, becoming the single regulator. At the same time, the Bank was given formal independence in the conduct of monetary policy, in the oversight of payment systems and in safeguarding the stability of the financial system. To complement the institutional framework, a Financial Intelligence Analysis Unit was established to strengthen the anti-money laundering regime and to combat the financing of terrorism.

As part of the authorities' efforts to create a reputable financial centre, in late 2002 the IMF / World Bank were requested to conduct a Financial Sector Assessment Programme (FSAP). The assessment concluded that Malta's financial system appeared to be healthy and well supervised, with a comprehensive legal framework and strong adherence to most international standards and codes. At the same time, the report also noted that, mainly because of the predominance of two large banks, the system was highly concentrated and exposed to the country's narrow economic base.

Malta as an international financial centre

EU membership in 2004 proved to be an important catalyst in the further development of the financial services industry. Malta now benefits from the greater credibility conferred by EU-compliant legislation and access to passporting rights in the vast European market, which allows licensed financial institutions to exploit previously unavailable avenues for growth.

Malta has also capitalized on its other strengths. Its small size facilitates access to the single regulator, allowing for a swift licensing process and the possibility of custom-made solutions. The financial services industry is supported by a modern telecommunications infrastructure and a plentiful supply of experienced, English-speaking tax professionals, legal and accounting firms and other service providers. Labour and rental costs are competitive, while Malta's geographical position enables it to serve as a finance hub in the Mediterranean region.

These attributes are complemented by a competitive tax regime. In the 2008 Forbes Tax Misery and Reform Index, Malta was classified as the fifth most tax-friendly country worldwide for companies and the most attractive in the EU. In addition, Malta has an extensive network of almost fifty double taxation treaties, and income earned overseas may be exempted from double taxation even when no bilateral treaty exists.

Malta's development as an international financial centre is reflected in the range of financial services available. Complementing the traditional retail functions, banks are increasingly offering private and investment banking, project finance, treasury services and syndicated loans. Malta also hosts a number of institutions specializing in trade-related products such as structured trade finance, factoring and forfeiting.

At the end of last year, the number of banks stood at 22, up from 17 in 2004. The assets of the banking system, including both the domestically and the internationally-oriented banks, totalled €41.9 billion at the end of 2008, an increase of 10.5% over 2007 and nearly double the total in 2004.

Other areas, too, have experienced rapid growth. These include fund management and collective investment schemes, captive insurance, asset management, back office processing facilities and call centres. Following the recent legislation on professional investment funds, considerable interest has also been shown by the hedge fund industry.

The establishment of specialized international institutions has enabled Malta to place 34th among 134 countries in terms of financial market sophistication, according to the Global Competitiveness Report 2008/09, published by the World Economic Forum. The same report ranks the balance sheet soundness of Maltese banks in the 10th place.

The sustained growth of the financial services industry is having positive effects on the real economy. The number of persons employed in the industry rose from 4,300 in 2004 to around 6,000 in 2008. Furthermore, these figures do not include the substantial employment created by support activities such as professional and business services.

The ingredients all seem to be in place, therefore, for this industry to continue to prosper in the future. The 2008 Global Financial Services Index, published by the City of London, ranks Malta fourth among the financial centres that have the potential to become significantly more important over the next few years, and fifth as the centre where organisations are most likely to open up new operations. The report describes Malta as a country "worth watching as it consolidates its position in the EU after adopting the euro".

The way forward: challenges in the short-term …

The challenge now is to live up to these lofty expectations. In the short-term, Malta's banking system must endeavour to emerge from the current downturn well equipped to seize the opportunities that will no doubt arise once the crisis has run its course. For this purpose, it will be important for the banks to build on their strengths and minimise their weaknesses.

With regard to the former, our banks start from a relatively strong position since their fundamentals have not been weakened by the financial crisis. The existence of a sound regulatory system, effective risk management practices and prudent lending policies have combined to minimise the banks' exposure to bad or dubiously-valued assets. Investment portfolios are in fact highly diversified, with minimal holdings of asset-backed securities, while the domestically-oriented banks' measured approach to credit is reflected in loan-to-deposit and residential loan-to-value ratios that average around 79% and 73%, respectively.

One of the lessons learned from the crisis is that a bank's funding model is crucial. The reliance by a number of international banks on wholesale funding proved to be a major source of weakness in time of stress. In contrast, Maltese banks have traditionally relied on retail deposits to fund their lending operations, a source of liquidity that has proved more reliable. This explains the banks' high liquidity ratios, currently averaging 46%. The steady supply of liquidity, combined with a sustained demand, have permitted the credit channel to remain intact, despite the ongoing global turmoil. As a matter of fact, bank lending to the private sector grew by 9.7% in the twelve months to April 2009, compared with 8.7% in the preceding twelve months.

Another lesson concerns the importance of a strong capital base. Here too, Maltese banks appear to be in a good position, with capital adequacy ratios averaging 15%. The banks' resilience in this regard is confirmed by the results of stress tests carried out recently by the Central Bank of Malta in connection with the Financial Stability Report published earlier this month.

Going forward, however, there can be no room for complacency, particularly during a recession. The latest projections indeed suggest that most major economies, including those in the euro area, will contract this year and a recovery is only likely to set in well into 2010. The Bank's most recent forecast for the Maltese economy, which was based on information available in February and which anticipated GDP growth in a range of 0.5% to 1.1% for 2009, is currently being revised to take account of the further deterioration in external conditions since then. Everything now suggests that, barring unforeseen developments, this year is likely to end with a marginally negative growth rate.

Just as there are increasing signs internationally that an adverse feedback loop between the real economy and the financial sector has taken hold, posing new challenges for financial stability, so also is it likely that our banks will become increasingly susceptible to the negative feedback from the expected further slowdown in the Maltese economy. Non-performing loans, which had fallen to more manageable levels in recent years, are likely to increase as debt-servicing capabilities weaken. This expectation is linked in particular to the significant concentration risk to which banks in Malta are exposed stemming from both a direct exposure, and indirectly through collateral, to the construction, property development and mortgage sectors. Taken together, property-related loans account for almost 60% of loans by the banking system to the private sector.

Profitability levels are also likely to be affected by slower growth in business volumes and squeezed interest margins due to increased competition for customer deposits. And as the repricing of risk is expected to continue in the near term, further downside pressure on earnings growth will come from write-downs in investment portfolios resulting from fair value adjustments.

While a prudent credit risk assessment process has long been a characteristic of banking practice in Malta, the importance of ensuring that the risk potential of assets is adequately understood and controlled bears emphasising at this time of uncertainty. The results of such monitoring need to be translated into appropriate internal ratings, classifications and loss recognition to develop an accurate picture of credit quality. The concentration risk referred to earlier, combined with the prospect of a prolonged period of slow growth, also suggests that banks would do well to strengthen capital buffers further beyond statutory ratios.

… and in the likely post-crisis scenario

While the immediate priority of the authorities during the ongoing crisis has been to restore calm to the financial markets, considerable attention has also been devoted to drawing lessons and devising remedies. It is very likely that once the dust has settled, banks everywhere will have to face a much changed operational and regulatory environment. This will entail a number of longer-term challenges. For a start, when established business models no longer work, innovation cannot be far behind. New banking institutions, both physical and virtual, will appear. This will accentuate the degree of competition in the limited retail deposit and loan markets and result in narrower interest rate spreads. In Malta, the traditional dependence on retail funding will also be put to the test. All this will happen against a backdrop of a more stringent regulatory regime. In sum, the challenge will be to meet the higher regulatory standards without stifling the dynamism that has characterised our banking industry in recent years.

In the remaining part of my remarks, I will focus on some issues that are likely to become especially relevant in the future.

New accounting regime

Changes in the regulatory framework are expected to include revisions to accounting rules. Accounting standards are a key aspect of the financial infrastructure and essential for market discipline. In line with the recommendations of the recent de Larosière Report, accounting standards should not distort business decisions or promote pro-cyclical behaviour nor discourage long-term investment.

Several standard-setting bodies had already emphasised the need for the exercise of sounder judgement in the estimation of fair values, particularly for instruments that do not trade in active markets. This raises concerns of both a macro- and micro-prudential nature.

Macro considerations relate to the pro-cyclical nature of the current accounting framework. The micro dimension relates to absence of depth in some financial markets, particularly in times of stress when liquidity problems arising from valuation adjustments are quickly transmitted to an institution's capital base. The presumption in the current valuation rules that a market value for a financial instrument exists does not necessarily hold during a crisis. The reclassification of assets in such circumstances would help financial institutions mitigate the problems arising from the inability to discover prices.

Another concept that is gathering support internationally is that of dynamic provisioning, which seeks to avoid the pro-cyclical impact of current accounting rules by recognising portfolio losses over the cycle. As a result, loss provisions are measured against the expected losses over the life of an asset rather than when losses are actually incurred. The losses made during a downturn can then be met from the accumulated buffer built up during the economic upswing.

Risk management practices and stress testing

Let me now turn to some risk management issues. Another lesson that has been learned from the financial turmoil is that proper liquidity management is of paramount importance to satisfy the banks' funding needs, and heightens their resilience against idiosyncratic or systemic risks. Although existing EU legislation on liquidity risk is highly fragmented, in part reflecting the various national approaches, adherence to a set of common principles such as those provided by the Basel Committee on Banking Supervision should prove fruitful. These principles promote sound liquidity risk management frameworks and formal contingency funding plans.

Payment systems are an important component of liquidity management. The efficient execution of payment instructions is vital, as payment failures can result not only in higher costs but also liquidity problems. It is, therefore, somehow not clear why banks in Malta have opted for only an indirect participation in TARGET2 when this means that they rely entirely on their foreign correspondents to settle payments in euro.

A recent survey carried out by the Central Bank of Malta indeed shows that this choice has occasionally given rise to operational problems and additional costs. Indirect participation, moreover, also carries a reputation risk in the event of a payment failure, and implies the need to have in place a contingency plan to cater for the operational failure of counterparties. In this respect, I am pleased to note that some banks are now considering direct participation in the system.

Another project which should help Maltese banks play a more active role in Europe is the Single Euro Payments Area (SEPA), which went live in 2008. SEPA represents the next major step towards closer European financial integration and is a further building block towards the realisation of the full potential of the Single Market. Its objective is to remove the distinction between domestic and cross-border payments, promoting efficiency and safety, minimising transactions costs and reducing bank charges.

Following the launch of the first SEPA payment product for credit transfers last year, the transposition of the Payments Services Directive into national law as from November 2009 will support direct debit schemes, thus opening up the possibility of using such instruments in the SEPA area, including Malta. Given its importance for our banking system, the Central Bank of Malta has launched a Consultative Paper on the National Implementation of the Payment Services Directive.

Malta stands to gain from SEPA. Along with the benefits of financial market integration, increased competition and scope for innovation, there is also a strong potential to attract e-commerce payment business and payment factory operations for trans-national corporations.

Investing in SEPA should not, therefore, be viewed as an expense, but rather as a business opportunity that will help banks pre-empt competition law problems, reduce costs and expand in new markets. In time, it may also come to offer new and profitable services, such as e-invoicing and reconciliation. For this to happen, the banks must see to it that their customers understand the advantages offered by SEPA and make use of it.

The financial crisis has also highlighted the importance of stress tests, which assess an institution's ability to withstand both institution-specific credit and liquidity risks as well as systemic risks, including adverse macroeconomic conditions. As stated in the Bank's Financial Stability Report, the latest stress test results show that the banks generally have adequate capital buffers and sufficient liquidity to withstand extreme, yet plausible shocks.

The tests carried out by the Bank should, however, be complemented by parallel tests conducted by individual institutions. In particular, banks should make an in-depth, bottom-up assessment of the potential implications of critical events to identify potential weaknesses at an early stage so as to be in a position to take early corrective measures. This would also serve to reduce the pro-cyclicality of such measures. In recognition of the need for a strong risk management framework, the Central Bank of Malta, in cooperation with the MFSA, has been working with a number of banks on their contingency funding plans and stress testing capacity.

A new supervisory regime

The lessons that are emerging from the financial crisis will almost certainly change the shape of financial regulation and supervision as we know it. The globalisation of financial institutions and markets, and the associated interdependencies, imply that a regime that has only a narrow institutional and geographic focus will prove inadequate. There is now a heightened recognition of the importance of the macro-prudential dimension of supervision and of the need to have mechanisms in place to address systemic risks, within and across national borders. In this regard, the recommendations contained in the de Larosière Report constitute an excellent basis for action.

The Report distinguishes between micro-prudential supervision (the supervision of individual institutions) and macro-prudential supervision (the limitation of the distress of the financial system as a whole to protect the overall economy from significant losses in real output). The fact that entire financial systems may be exposed to common and systemic risks is not always fully taken into account in micro-prudential supervision. The two processes, however, are essential and complementary components of an effective monitoring system for financial stability. Indeed, macro-prudential supervision cannot be meaningful unless it can somehow impact on supervision at the micro-level; while micro-prudential supervision cannot effectively safeguard financial stability without adequately taking account of macro-level developments.

An improved domestic framework for macro-prudential supervision should mirror these international developments. Although the stress tests have shown that banks in Malta are for the most part adequately capitalised, they may still need to strengthen their capital buffer to cover Pillar II risks, such as concentration and interest rate risks, once the requirements of the Capital Requirements Directive are fully implemented.

The high exposure to property-related loans, which I referred to earlier, represents a potential systemic risk and thus falls within the purview of macro-prudential supervision. The Bank has both a statutory responsibility as well as the necessary expertise for assessing systemic risks. In this context, the importance being given in the global debate to endowing macro-prudential regulators with the necessary policy tools beyond what they have now, namely moral suasion, should be echoed domestically. Micro- and macro-prudential supervision should go hand in hand. This would also provide reassurance to the banks, complementing their own efforts to overcome the challenges I have outlined here today.

Conclusion

While Maltese banks have been spared the full impact of the financial crisis, in the years ahead they will be operating in an environment that is likely to have changed as a result of the crisis. Our banks, too, will face tougher regulation, higher capital requirements and, perhaps, also scarcer funding. They will have to strengthen their capacity to manage risk and growth itself. The small size of the domestic market, moreover, will require them to be more innovative and outward looking, exploiting the opportunities of the Single Market and of Malta's strategic location on the EU's southernmost frontier. Only in this way will they be able to compete and continue to play a vital role in support of a modernising and growing economy.